Supreme Court, U.S.
FILED
MAR 13 1989
JOSEPH F. SPANIOL, JR.
CLERK

Nos. 88-1144, 88-1339

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

PENTHOUSE INTERNATIONAL, LTD. and
BOARDWALK PROPERTIES, INC.,
Petitioners and Cross-Respondents,
v.
DOMINION FEDERAL SAVINGS & LOAN ASSOCIATION,
Respondent and Cross-Petitioner,
and
MELROD, REDMAN & GARTLAN, P.C., and QUEEN CITY
SAVINGS & LOAN ASSOCIATION,
Respondents.

Petition For A Writ Of Certiorari To The United States Court of Appeals For The Second Circuit

PETITIONERS' REPLY BRIEF AND RESPONSE TO CROSS-PETITION FOR A WRIT OF CERTIORARI

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PETITIONERS' REPLY BRIEF AND RESPONSE TO CROSS-PETITION FOR A WRIT OF CERTIORARI[1]

When a federal court of appeals determines in a diversity case that the district court overlooked a critical legal issue, the appellate court must identify the correct legal standard under state law, and remand the case to the district court for any necessary factual findings under that standard. *Pullman-Standard* v. *Swint*, 456 U.S. 273 (1982). In this case the court of appeals did neither. In violation of *Erie R. Co.* v. *Tompkins*, 304 U.S. 64 (1938), the court of appeals, having decided that it must determine the loan commitment's expiration date, ignored controlling New Jersey law regarding the legal effect to be given that date and the parties' ability to waive or extend it through their conduct. Contrary to the holding of *Pullman-Standard*, *supra*, the court of appeals made *de novo* factual findings about the expiration date and related factual issues, instead of remanding the case for determination of those issues.

Dominion Federal Savings & Loan Association and the law firm of Melrod, Redman & Gartlan, P.C. (hereinafter "respondents") fail to confront these fundamental flaws in the decision below. Although federal appellate courts have a duty "to ascertain and apply the state law where . . . it controls decision," *Huddleston* v. *Dwyer*, 322 U.S. 232, 236 (1944), respondents do not even attempt to support the court of appeals on the ground that it actually considered the principles of New Jersey law governing contract expiration dates.[2] (Resp. Br. at 13.)

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[1] Pursuant to Rule 28.1 of the Rules of this Court, we hereby state that Penthouse International, Ltd. and Boardwalk Properties, Inc. are privately held corporations.

[2] Respondents' assertion that the court of appeals "cited unimpeachable New Jersey authority throughout its opinion" (Resp. Br. at 13) misses the point that the court never considered the law of New Jersey governing contract expiration dates. The New Jersey authority cited by the court of appeals concerned general principles of contract interpretation.

Respondents concede—contrary to what the court of appeals said—that Dominion had legal obligations to petitioners *after* the supposed March 1, 1984, expiration date of the loan commitment. (Resp. Br. at 14.) But they do not explain what those obligations were or why they were not breached through the conduct condemned by the district court. Furthermore, respondents do not address directly our contention that the court of appeals found facts for the first time on appeal and they do not even cite the *Pullman-Standard* decision.

The two serious errors of federal law committed below in this reversal of a $128.7 million judgment, the significance of this case to the rapidly developing field of "lender liability" law, and respondents' failure to stand behind the court of appeals' own analysis, make this an appropriate case for the exercise of this Court's supervisory power.[3] The Court should grant the Petition, vacate the judgment, and remand to the court of appeals with instructions to remand to the district court for factual findings under the controlling state law principles.

1. Respondents seek to downplay the significance of this case, claiming that the case "caused a stir in the lending industry" only because the district court "expressed its findings in unusually harsh language." (Resp. Br. at 2.) To the contrary, the nation's foremost business journal described the decision below as a "sweeping ruling that will help shield lenders from borrower lawsuits," and will have broad impact "[b]ecause there have been few appellate decisions to guide trial courts in this relatively new area of law, and because Second Circuit rulings are influential in business matters . . . ." Wall St. J.,

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[3] The Court's exercise of its supervisory power is especially appropriate here because improper appellate fact-finding, by definition, does not become apparent until after the court of appeals rules. "As the Court of last resort in the federal system, we have supervisory authority and therefore must occasionally perform a pure error-correcting function in federal litigation." *Florida* v. *Rodriguez*, 469 U.S. 1, 7 (1984) (Stevens, J., dissenting).

Aug. 29, 1988, at 2. The appellate court's decision was also hailed by the lending industry as "signal[ling] a new judicial approach to the law of lender liability" that emphasizes "the formal, written agreement of the parties . . . over the informal oral communications." T. Boudreau, *The Penthouse Reversal*, 2 LENDER LIABILITY REP. 1, 3 (Nov. 1988).[4] These factors, not the supposedly "harsh" tone of the district court's opinion, demonstrate the legal significance of this case and account for the great attention it has received.

2. Our Petition explained that the court of appeals ignored controlling New Jersey law when it held that "the parties' conduct in continuing to negotiate after March 1st," although "consistent with an implied extension of the expiration date," could not extend the parties' obligations because that would be "inconsistent with [the loan commitment's] clear language." (Pet. App. 30a.) From what source the court of appeals derived the legal principle embodied in that holding is impossible to tell from the opinion or from respondents' brief in opposition. The court certainly did not rely on New Jersey law, which embraces a contrary principle. New Jersey law provides that a contract expiration date is not immutable if the parties did not agree to make "time of the essence," and that even if they did, the parties' conduct can have the effect of waiving or extending the expiration date.[5] (*See* Pet. at 15-18.)

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[4] *See* W. Dennis & M. Endler, *Bank of America and Penthouse: Is the Lender Liability Pendulum Swinging Back?*, 43 CONSUMER FIN. L. Q. REP. 3 (Winter 1989) (commenting that decision below, along with a recent state court decision, "may signal a change in the judiciary's attitude regarding lender liability suits and an unwillingness to further extend the liability of lenders for requiring strict adherence to loan agreements"). *See also* R. Fries, *Mortgage Lenders Found Increasingly Accountable*, Nat'l L. J. 14 (Feb. 6, 1989).

[5] *Selective Builders, Inc.* v. *Hudson City Savings Bank*, 137 N.J. Super. 500, 349 A.2d 564, 566 (N.J. Super. Ct. Ch. Div. 1975); *Salvatore* v. *Trace*, 109 N.J. Super. 83, 262 A.2d 409, 413 (N.J. Super. Ct. App. Div. 1969), *aff'd per curiam*, 55 N.J. 362, 262 A.2d 385 (1970).

Respondents nevertheless suggest that this error is not worthy of the Court's review because it involves an "unremarkable line of New Jersey authority" which was "'well-established'" in New Jersey "years ago." (Resp. Br. at 12.) The settled nature of these New Jersey principles, however, makes the court of appeals' failure to consider them more egregious, not less. The Court has exercised its supervisory power to assure that the federal courts of appeals follow the most recent state court decisions. *See Exxon Co., U.S.A.* v. *Banque de Paris et des Pays-Bas*, ___ U.S. ___, 109 S. Ct. 299 (1988). The exercise of that power is still more appropriate when the court of appeals fails to follow well-settled state law and inexcusably breaches its duty, under *Erie*, to "ascertain and apply" the controlling state law. *Huddleston*, *supra*, 322 U.S. at 236. Our argument is not, as respondents characterize it, that New Jersey law was "misapplied." (Resp. Br. at 3.) The problem here is that the court of appeals entirely ignored New Jersey law that bore directly on the critical questions decided on appeal.

3. According to respondents, the court of appeals would have reached the same result even if it had properly applied the controlling state law. (Resp. Br. at 13-14.) But that proposition, resting on the notion that "there was no evidence to support a finding that the March 1 deadline date was mutually extended or waived" (Resp. Br. at 14), cannot be sustained.[6] The court of

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[6] Respondents offer a selective and misleading statement of the controlling New Jersey law when they assert that any waiver or extension of an expiration date "'must take the form of an agreement founded on valuable consideration'" or "'a clear, unequivocal and decisive act showing such purpose as to amount to estoppel *in pais*.'" (Resp. Br. at 14) (emphasis omitted.) This language, quoted from the *Selective Builders* decision, was accompanied by a statement that waiver of an expiration date "may be expressed or *implied* by written or oral agreement *or by conduct* indicating an intention to waive." 349 A.2d at 567 (emphasis added). Furthermore, the elements of a waiver or extension have nothing to do with the preliminary and separate question whether "time is of the essence" in a loan commitment.

appeals itself recognized that the parties' conduct "may be consistent with an implied extension of the expiration date" (Pet. App. 30a) because negotiations continued after March 1, 1984, and the court also noted that the lenders specifically chose not to terminate the loan commitment on that date.[7] (Pet. App. 18a, 30a.)

Rather than backing the plain holding of the court of appeals, respondents run away from it. According to them, the court of appeals "did *not* hold . . . that the instant a written time limit is allowed to expire, 'the lenders are thereby relieved of any further legal obligations to the borrower.'" (Resp. Br. at 14) (emphasis added.) But that is precisely what the court of appeals did hold. If the court had thought Dominion had legal obligations to Penthouse that continued after March 1, it necessarily would have identified them and explained why those obligations were not breached through conduct which the district court viewed as an "unambiguous refusal to close." (Pet. App. 88a.) The court of appeals' silence on this score shows beyond doubt that it viewed Dominion's obligations at an end on March 1.

Respondents further suggest that the court of appeals simply held that the district court could not rely on "acts by

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[7] Respondents complain that the "time of the essence" doctrine relied upon in the Petition was "not asserted in the court below." (Resp. Br. at 13.) But petitioners cited and discussed *Selective Builders*, one of the leading New Jersey cases on point. (*See* Pet. at 16 n.12.) Respondents also ignore that petitioners had no reason to anticipate that the court of appeals would select March 1, 1984, as the cut-off point for determining whether Dominion's conduct amounted to an anticipatory breach, since the district court made no finding regarding the commitment expiration date and since Dominion concedes that "the expiration date was not relied upon as Dominion's excuse for not closing." (Resp. Br. at 14.) Rather, the principal thrust of Dominion's argument below was that Penthouse was unable to satisfy the pre-closing conditions and those conditions were not waived. Brief for Defendant-Appellant Dominion Federal Savings & Loan Association, at 39-53 (Jan. 15, 1988).

Dominion and its counsel after March 1 as supposed evidence of 'anticipatory breach,'" and, astonishingly, assert that "the expiration date was not relied upon as Dominion's excuse for not closing" because "Penthouse was nowhere near ready to close." (Resp. Br. at 14.) Thus, even now, respondents eschew any reliance on the loan commitment's expiration date as the reason for Dominion's refusal to close the loan. Yet that expiration date was critical to the court of appeals' holding that there was no anticipatory breach because conduct after March 1, 1984, was "not relevant to our inquiry." (Pet. App. 34a.) The confused nature of respondents' own position, and its inconsistency with the reasoning of the court below, underscores the need for this Court's review. When a court of appeals adopts a legal theory not advanced by the appellants, and in doing so fails to apply controlling state law, that violation of the basic *Erie* rule should not go uncorrected in a case of such major legal and practical consequence.

4. We explained in our Petition that the court of appeals made an improper *de novo* factual finding when it proceeded on its own to determine the expiration date of the loan. (Pet. 20-24.) Although the court purported only to "construe the terms of relatively unambiguous documents" (Pet. App. 30a) in finding that March 1, 1984, constituted the commitment expiration date, it considered extrinsic evidence favoring its own view (ignoring other evidence to the contrary)[8] and conceded that "[t]he district court did not specifically find that the parties extended the expiration date to March 1st . . . ." (Id. at 29a.)

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[8] In our Petition (at 21 n. 19), we noted various factors indicating that the March 1, 1984, date was merely a "projected closing date" and was not even treated as an expiration date by Dominion, which was telling loan participants as late as February 6, 1984, that the loan would close "in February or *March* of 1984." (Pet. App. 108a) (emphasis added.)

In so ruling, the court below violated the clear holding of *Pullman-Standard, supra*,[9] and many other recent decisions of this Court cautioning the federal courts of appeals not to engage in appellate fact-finding.[10] The Court has not hesitated in similar cases to grant *certiorari*, and to reverse summarily and remand with instructions for the court of appeals to remand for findings of fact by the district court, and we urge the Court to do the same here. *E.g.*, *Dennison Manufacturing Co.* v. *Panduit Corp.*, 475 U.S. 809 (1986); *Lehman* v. *Trout*, 465 U.S. 1056 (1984) (remanded for findings of fact "based on new evidence if necessary").

Respondents nowhere answer our contention that the *Pullman-Standard* rule was violated. The best they can manage is the assertion that the district court "implicitly found a March 1, 1984 deadline when it concluded that the title problems 'could have been resolved in time to close the deal before March 1, 1984.'"[11] (Resp. Br. at 7.) This supposed "implicit"

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[9] "When an appellate court discerns that a district court has failed to make a finding because of an erroneous view of the law, the usual rule is that there should be a remand for further proceedings to permit the trial court to make the missing findings . . . ." *Pullman-Standard, supra*, 456 U.S. at 291.

[10] *E.g.*, *Amadeo* v. *Zant*, ____ U.S. ____, 108 S.Ct. 1771, 1780 (1988); *Icicle Seafoods, Inc.* v. *Worthington*, 475 U.S. 709 (1986); *Anderson* v. *City of Bessemer City*, 470 U.S. 564, 573 (1985); *Inwood Laboratories, Inc.* v. *Ives Laboratories, Inc.*, 456 U.S. 844, 857 n. 19 (1982).

[11] At all events, the language respondents quote from the district court's opinion regarding the parties' selection of March 1, 1984, as the projected or planned closing date says nothing with respect to the loan commitment's expiration date. Similarly, Penthouse's complaint alleged only that the loan commitment was "extended to March 1, 1984," and no issue was raised at trial that such date was either immutable or controlling. (*See* Resp. Br. at 7.) To the contrary, the evidence petitioners adduced at trial indicated that March 1 was

finding, however, cannot logically be squared with the district court's *explicit* finding that an "anticipatory breach" (by definition occurring *before* the date set for performance) occurred because of conduct "during February and March 1984." (Pet. App. 87a.) The court of appeals' opinion simply cannot be salvaged on the basis of some so-called "implicit" lower court finding.

5. Respondents seriously misconstrue our Petition, and the decision of the court of appeals, by suggesting that we are asking this Court to review the court of appeals' conclusion that certain district court findings were "clearly erroneous." (Resp. Br. at 3, 15.) The court of appeals' entire decision was premised on its legal conclusion that the petitioners' "anticipatory breach" claim could not be decided without first determining when the loan commitment was to expire. Only after the court of appeals made the *de novo* determination that the loan commitment expired on March 1, 1984, did it proceed to rule that the district court made "clearly erroneous" findings respecting petitioner's ability to satisfy pre-closing conditions by that date and the occurrence of an unambiguous refusal to close by that date. (*See* Resp. Br. at 3-4.) We are not asking this Court to review these "clearly erroneous" rulings of the court of appeals; we ask only that the legal premise of those rulings be reviewed.

6. In our Petition we argued that the court of appeals also violated the principles of *Erie* and *Pullman-Standard* when it held that Queen City Savings & Loan Association ("Queen City") had no "authority" as lead lender to waive Penthouse's exact compliance with various pre-closing conditions by ac-

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merely a "projected closing date" (Pet. at 21 n. 19; J.A. 860), and at the close of the trial the district court conformed the pleadings to the evidence. (Pet. App. 64a.) *See* Fed. R. Civ. P. 15(b). This evidence was supported by Dominion's own expert, who testified that closing dates are not controlling, which is consistent with New Jersey law and at odds with the court of appeals' decision. (Pet. at 19.)

cepting "substitute performance."[12] (Pet. at 24-26.) The authority of Queen City to accept "substitute performance" not amounting to a "material change" in the pre-closing conditions was a fact-bound issue inappropriate for *de novo* decision by the court of appeals. (Pet. at 25.) The appellate court, while ruling on the subject, also paid no heed to the New Jersey law of estoppel, which provides the legal standards for determining whether Queen City's actions were binding on the other financial institutions participating in the $97 million loan. (*Id.* at 26.)

Without the court of appeals' finding that Queen City had no "authority" to accept "substitute performance," respondents' argument that petitioners were "nowhere near ready to close" by March 1 (Resp. Br. at 14) collapses, as indeed it should. The court of appeals acted contrary to "the understanding held in much of the industry," W. Dennis & M. Endler, note 2 *supra* at 7, by holding as a matter of law that a lead lender in a large syndicate is not authorized to decide which loan conditions can be satisfied through substitute arrangements without "material" change. (Pet. App. 40a.)

7. We do not oppose the "protective" cross-petition for a writ of certiorari filed by Dominion, which seeks review of the district court's dismissal of Dominion's third-party claim against Queen City. (*See* Resp. Br. at 4 n.5.) If this Court should grant our Petition and remand the case to the court of appeals with instructions for a further remand to the district court, the district court can properly consider anew Dominion's third-party claim in light of the correct state law standards and its own factual findings.

* * *

Review of this case is warranted to assure that controlling law is applied to the facts by the judges experienced in and

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[12] Although respondents now complain that we refer to a "waiver" of pre-closing conditions as the acceptance of "substitute performance" (Resp. Br. at 5), the latter term was used repeatedly by the court of appeals itself. (*See, e.g.*, Pet. App. 11a, 12a, 41a.)

properly charged with fact-finding. No exception to the basic requirements of *Erie* and *Pullman-Standard* exists when a district court expresses itself in language branded as "intemperate" by those who have felt its sting. (Resp. Br. at 16.) Regardless whether the court of appeals harbored a different view, or simply overstepped its bounds, it was mistaken. Its error should not go uncorrected in a case of this consequence.

CONCLUSION

For the reasons stated above and in our Petition, the Petition for a writ of certiorari should be granted.

Respectfully submitted,

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Dated: March 13, 1989